OCSLA respecting rates for gas pipeline services?

5. Does the OCSLA provide sufficient remedial authority for the Commission to ensure nondiscriminatory access by prohibiting discriminatory or excessive rates?

6. Does the OCSLA provide the Commission with sufficient authority to protect the interests of historical customers of existing offshore interstate pipelines if these pipelines were declared to be gathering facilities?

7. Is it feasible, as a matter of law and policy, to adopt a light-handed regulatory approach that relies on complaints about discriminatory access or rates?

8. If such an approach is adopted, is there a need to distinguish between new and existing pipelines to determine how much regulation is necessary? What would be the legal and policy basis for any such distinction?

9. What are the implications of a change in OCS gathering policy on existing OCS interstate pipelines that may wish to retain their jurisdictional status or on existing, interstate pipeline-owned, OCS transmission facilities that wish to retain a transmission classification for those facilities?

10. How much, if any, OCS gas is processed at locations other than onshore or in shallow waters?

B. Should the Commission issue a rule under the NGA declaring all pipeline facilities on the OCS to be nonjurisdicational gathering facilities and simultaneously issue a rule under the OCSLA imposing terms and conditions on OCS facilities to protect existing shippers on existing OCS interstate pipelines or on existing OCS transmission facilities?

1. What would be the practical effect of these rules?

2. Does the Commission have sufficient authority under the OCSLA to prohibit, eliminate or alter rates that are clearly discriminatory or rates that are so high that they would have the effect of denying access to shippers?

3. What would be the impact of the Commission's ceasing to regulate any offshore pipeline rates under the ''just and reasonable'' standard of sections 4 and 5 of the NGA?

4. Is here a legal basis under the OCSLA for the Commission to regulate generally the level of rates for services performed by OCS pipelines?

5. What conditions could the Commission require under the NGA and/or the OCSLA to protect historical customers of currently regulated OCS pipelines if their facilities are declared to be exempt gathering facilities?

6. Under this option, should the Commission consider allowing all rate regulation to end at any point that a pipeline and a (non-affiliated) shipper agree? (This option would be similar to recent proposals for ''recourse rates''.[12])

C. Should the Commission issue a rule under the NGA declaring all pipeline facilities on the OCS to be jurisdictional transportation facilities, but only regulate transportation rates for historical customers on existing interstate pipelines and for non-owner shippers on new facilities?

1. What would be the practical effect of such a rule?

2. Does a ''regulatory gap'' exist on the OCS that would support the issuance of such a rule?

3. What legal support is there for the Commission's regulating only those pipelines that transport non-owner shipper gas?

4. Is there any need to regulate the rates charged new customers that have not relied upon or have no expectation of NGA regulation?

5. Would the provisions of the OSCLA provide sufficient protection from undue discrimination to both historical and new customers of OCS pipelines?

6. Under this option, should the Commission consider allowing all rate regulation to end at any point that a pipeline and a (non-affiliated) shipper agree? (This option would be similar to recent proposals for ''recourse rates''.[13])

D. Should the Commission continue the application of the ''modified primary function'' test on a case-by-case basis? What would be the effects of this approach?

VI. Procedure for Comments

The Commission invites interested persons to submit comments, data, views, and other information concerning the matters set out in this notice.

To facilitate the Commission's review of the comments, commenters are requested to provide an executive summary of their position on the issues raised in the NOI. Commenters are requested to identify the specific question posed by the NOI that their discussion addresses and to use appropriate headings. Additionally, commenters should double space their comments.

The original and 14 copies of such comments must be received by the Commission before 5:00 p.m., Friday, January 12, 1996. Comments should be submitted to the Office of the Secretary, Federal Energy Regulatory Commission, 888 First Street, NE., Washington DC 20426 and should refer to Docket No. RM96–5–000.

In addition, commenters are asked to submit their written comments and executive summaries on a 3 1/2-inch diskette formatted for MS-DOS based computers. In light of our ability to translate MS-DOS based materials, the text need only be submitted in the format and version that it was generated (*i.e.* MS WORD, WordPerfect, ASC III, etc.) For Macintosh users, it would be helpful to save the documents in word processor format and then write them to files on a diskette formatted for MS-DOS machines.

By direction of the Commission.

Lois D. Cashell,

Secretary.

[12] Under ''recourse rates'', pipelines would be free to offer negotiated rates. Customers could choose either negotiated rates or they could choose the pipeline's on-file, cost-of-service rates.

[13] *See* n. 13 *supra.*

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[INTL–0003–95]

RIN 1545–AT92

Source of Income From Sales of Inventory and Natural Resources Produced in One Jurisdiction and Sold in Another Jurisdiction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations governing the source of income from sales of natural resources or other inventory produced in the United States and sold in a foreign country or produced in a foreign country and sold in the United States. This document affects persons who produce natural resources or other inventory in the United States and sell in a foreign country, or produce natural resources or other inventory in a foreign country and sell in the United States. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of oral comments to be presented at the public hearing scheduled for April 10, 1996, at 10 a.m. must be received by March 11, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL–0003–95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (INTL–0003–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Anne Shelburne, (202) 622–3880; concerning submissions and the hearing, Ms. Christina Vasquez, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by February 9, 1996.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information requirements are in proposed §§ 1.863–1(b)(6) and 1.863–3(e)(2). This information is required by the IRS to monitor compliance with the federal tax rules for determining the source of income from the sale of natural resources or other inventory produced in the United States and sold in a foreign country or produced in a foreign country and sold in the United States. The likely respondents are taxpayers who produce natural resources or other inventory in the United States and sell in a foreign country, or who produce natural resources or other inventory in a foreign country and sell in the United States. Responses to this collection of information are required to properly determine the source of a taxpayer's income from such sales.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: 1125 hours. The estimated annual burden per respondent varies from 1 hour to 5 hours, depending on individual circumstances, with an estimated average of 2.6 hours.

Estimated number of respondents: 425.

Estimated annual frequency of responses: One time per year.

Background

These proposed regulations contain rules relating to the source of income from the sale of certain natural resources and other inventory. These regulations are proposed to be effective for taxable years beginning 30 days after publication of final regulations. However, taxpayers may elect to apply these regulations for taxable years beginning after July 11, 1995.

Explanation of Provisions

I. Natural Resources

A. Current Regulations

Section 863 authorizes the Secretary to promulgate regulations allocating or apportioning to sources within or without the United States all items of gross income, expenses, losses, and deductions other than those items specified in sections 861(a) and 862(a).

Section 1.863–1 of the existing regulations contains rules for determining the source of income derived from the sale of certain natural resources. Generally, under paragraph (b)(1) of those regulations, income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber located within the United States and from the sale by the producer of the products within or without the United States ordinarily must be included in gross income from sources within the United States. However, if a taxpayer can show to the satisfaction of the District Director that, due to peculiar conditions of production and sale or for other reasons, not all of the gross income derived therefrom should be allocated to sources within the United States, the source of the income generally is determined under the 50/50 method described in § 1.863–3(b)(2) *Example 2.* The regulations do not define ''peculiar conditions of production and sale.'' In addition, § 1.863–1(b)(2) permits the Commissioner to make an allocation or apportionment that more clearly reflects the proper source of a taxpayer's income, if the Commissioner determines that the application of paragraph (b)(1) does not result in the proper allocation or apportionment of income. Similar rules apply in the case of natural resources produced without the United States and sold within the United States. See § 1.863–6. Thus, income from the sale of such products ordinarily will be allocated entirely to foreign sources.

B. Issues Under Current Regulations

The IRS and Treasury have reexamined the existing regulations under section 863 regarding natural resources and arrived at several conclusions. First, certain ambiguities in existing § 1.863–1 should be clarified. For example, the regulation does not define the term ''peculiar conditions of production and sale,'' and there is virtually no authoritative guidance as to the scope of that term. To the extent that ''peculiar conditions of production and sale'' is defined narrowly, the regulation may lead to inappropriate results when determining the source of income from the sale of processed natural resources. For example, if a U.S. corporation harvests timber to manufacture furniture for export, all of its income may be from sources within the United States. However, if another U.S. corporation purchases cut timber to manufacture furniture for export from the United States, one-half of that taxpayer's income may be from sources without the United States under the 50/50 method.

Second, the interaction of the existing regulations and the recently-issued consolidated return regulations may cause inappropriate sourcing results. On July 11, 1995, the IRS and Treasury issued final regulations under § 1.1502–13 [TD 8597 (60 FR 36671)], treating members of a U.S. consolidated group as a single entity for purposes of determining the source of a taxpayer's income. The IRS and Treasury understand that inappropriate results may occur when the current section 863 regulations are applied to certain consolidated groups on a single entity basis. For example, a U.S. corporation that is a member of a consolidated group may extract oil abroad. The oil is then transported to the United States where it is refined by another member of the consolidated group. It is sold in the United States through other members of the consolidated group. Under § 1.1502–13 of the consolidated return rules, the consolidated group is treated as a single entity, and the source of income from the sale of oil must be determined under section 863. Because the consolidated group refines the oil outside the country of extraction, it may be that peculiar conditions of production and sale exist, and the exclusive sourcing rules of paragraph (b)(1) do not apply. Thus, the taxpayer would generally determine the source of its income under the 50/50 method described in § 1.863–3(b)(2) *Example 2.* Under this method, 50 percent of the consolidated group's income would be U.S. source income based on the place of sale. However, this calculation may understate the appropriate amount of the taxpayer's foreign source income because the value of the oil as extracted may represent more than 50 percent of the total value of the product that is finally sold in the United States. The preamble to the regulations under § 1.1502–13 indicated that the IRS and Treasury would consider amending the regulations under section 863 to address these concerns.

Accordingly, the IRS and Treasury are issuing proposed regulations under section 863 to clarify ambiguities in the existing regulation and to address concerns created by the new § 1.1502–13 regulations.

C. Proposed Regulations

Section 1.863–1(b) provides special rules for determining the source of income from the sale of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, within the United States and the sale of these products without the United States. The proposed regulations also provide special rules for determining the source of income from the sale of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, without the United States and the sale of these products within the United States. The export terminal rule of paragraph (b)(1) provides that the source of gross receipts from the sale of such products equal to the fair market value of the product immediately prior to export (referred to in the proposed regulations as the export terminal) is determined according to where the farm, mine, oil or gas well, other natural deposit or timber is located. Separate rules are provided for determining the source of any gross receipts in excess of the fair market value of the product at the export terminal. Paragraph (b)(2) provides an exception to the approach of paragraph (b)(1) where, prior to export, the taxpayer engages in substantial production activities in addition to activities related to the ownership or operation of a farm, mine, oil or gas well, other natural deposit, or timber.

1. Export Terminal Rule

Under the export terminal rule of paragraph (b)(1), gross receipts derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, and sale of the products derived therefrom, are allocated between sources within and without the United States based on the fair market value of the product at the export terminal. The export terminal is the last point from which the product is sent from the United States to a foreign country or the last point from which goods are sent from a foreign country to the United States. For example, if a U.S. corporation extracts oil in one foreign country, sends the crude oil to a port in a second foreign country via pipeline, and delivers the oil to a U.S. refinery by ship, the export terminal would be the port in the second foreign country where the crude oil was loaded onto the ship.

Under the export terminal rule, the source of gross receipts equal to the fair market value of the product at the export terminal is determined by the location of the farm, mine, well, deposit, or uncut timber. The source of gross receipts in excess of the fair market value of the product at the export terminal (excess gross receipts) is determined according to whether the taxpayer engages in any additional production activity following export. A taxpayer will be treated as performing production activities in addition to the activities of owning or operating a farm, mine, oil or gas well, other natural deposit, or timber based on the principles of § 1.954–3(a)(4). However, activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, will not be considered additional production activities. Thus, § 1.863–1 *Example 2* illustrates that liquefaction of natural gas would not constitute additional production activities. In addition, activities such as delimbing and debarking trees, sorting grain, and treating and stabilizing oil would ordinarily not constitute additional production activities. In contrast, the transformation of timber into furniture is not done to prepare the natural resource itself for export, and would constitute additional production activity. Production activities are defined in § 1.863–1(b)(3)(i).

If no additional production occurs following export, paragraph (b)(1)(i) requires that the source of the excess gross receipts be determined according to where the farm, mine, well, deposit, or uncut timber is located.

However, under paragraph (b)(1)(ii), if the taxpayer engages in additional production activities after the export terminal and outside the country of sale, the source of excess gross receipts is determined under the rules of § 1.863–3. For example, if a U.S. corporation extracts oil in a foreign country, refines the oil in the United States, and sells the refined product in another foreign country, the source of gross receipts in excess of the fair market value of the product when it is exported from the first foreign country must be determined under one of the three methods described in § 1.863–3 (i.e., the 50/50 method as described in § 1.863–3(b)(1), the IFP method described in § 1.863–3(b)(2), or, if permitted by the District Director, the books and records method as described in § 1.863–3(b)(3)).

In any case not described in either paragraph (b)(1) (i) or (ii) of the proposed regulations, the source of the excess gross receipts is determined according to the place of sale pursuant to paragraph (b)(1)(iii). This rule would apply, for example, in the case where the taxpayer engages in additional production activities in the country of sale.

Paragraph (b)(1) addresses the concerns of U.S. corporations involved in the production of natural resources abroad and the application of the new § 1.1502–13 consolidated return regulations, by allowing them to treat the value of the natural resources at the point of export as income from sources where the farm, mine, well, deposit, or uncut timber is located. This rule has no effect on the rules governing foreign oil and gas extraction income under section 907(c)(1).

On November 28, 1995, the Tenth Circuit affirmed the Tax Court decision in *Phillips Petroleum* v. *Comm'r,* 97 T.C. 30 (1991), which held existing § 1.863–1(b)(1) invalid to the extent it allocates income from the sale of U.S. natural resources solely to sources within the United States. *Phillips Petroleum* v. *Comm'r,* No. 94–9021 (10th Cir. Nov. 28, 1995). The IRS and Treasury will consider the implications of this decision when finalizing these proposed regulations.

2. Additional Production Prior to Export Terminal

Paragraph (b)(2) provides a special rule for determining the source of income where a taxpayer performs substantial additional production activities before the product leaves the export terminal. Under paragraph (b)(2), the source of gross receipts equal to the fair market value of the product prior to the additional production activities is based on the location of the farm, mine, well, deposit, or uncut timber. The source of gross receipts in excess of the fair market value of the products at the beginning of the additional production activities is determined under the rules of § 1.863–3.

3. Other Rules

The proposed regulation contains rules for determining the fair market value of relevant products. For this purpose, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Thus, these rules for determining fair market value are consistent with the foreign oil and gas rules contained in § 1.907(c)–1(b)(6). In addition, fair market value determinations must be consistent with prices charged in sales, if any, to related parties in a transaction that is subject to section 482. For example, if a member of a U.S. consolidated group extracts natural resources in a foreign country and sells the natural resources to another member of the same group at the export terminal, the value of the natural resources determined at the export terminal should be the price charged by the producing member to the purchasing member for purposes of section 482.

Under paragraph (b)(5), a taxpayer's gross income from sources within or without the United States is determined by reducing its gross receipts from sources within or without the United States by the cost of goods sold properly attributable to such gross receipts. Under paragraph (c), a taxpayer's taxable income from U.S. or foreign sources must be determined under the rules of §§ 1.861–8 through 1.861–14T.

Under paragraph (b)(6), taxpayers must fully explain the methodology used, the facts describing substantial additional production activities (if any), and the determination of fair market value in a statement attached to the taxpayer's return. In addition, taxpayers must provide such other information as is required by § 1.863–3(e)(2).

Taxpayers may elect to apply the rules of these regulations for taxable years beginning after July 11, 1995. Otherwise, these regulations are effective for taxable years beginning 30 days after the publication of this regulation as a final regulation.

II. Inventory Other Than Natural Resources

A. Current Regulations

Section 863 authorizes the Secretary to promulgate regulations allocating or apportioning to sources within or without the United States all items of gross income, expenses, losses, and deductions other than those specified in sections 861(a) and 862(a).

Section 1.863–3 of the current regulations governs the source of income from the sale of inventory produced (in whole or in part) in the United States and sold in a foreign country, or produced (in whole or in part) in a foreign country and sold in the United States (Section 863 Sales). Section 1.863–3 provides three methods, set forth in the form of three examples, to determine the source of income from Section 863 Sales.

§ 1.861–3(b)(2) *Example 1* of the current regulations illustrates how an independent factory or production price (IFP) applies to determine the income attributable to production (IFP method). An IFP generally is established if a taxpayer regularly sells part of its output to wholly independent distributors in such a way as to reasonably reflect the income attributable to production activity. If an IFP exists, taxpayers must use the IFP method to determine the income attributable to production activities in both the sale establishing the IFP and in sales of similar products. See *Phillips Petroleum* v. *Comm'r*, 97 T.C. 30 (1991), *aff'd*, No. 94–9021 (10th Cir. Nov. 28, 1995); Rev. Rul. 88–73 (1988–2 C.B. 173). Gross receipts in excess of the IFP are attributable to sales activity. Taxpayers can otherwise establish an IFP by showing to the satisfaction of the District Director that an IFP exists. Notice 89–10 (1989–1 C.B. 631) contains additional rules regarding the application of the IFP method. Section 1.863–3(b)(2) *Example 1* of the current regulations does not provide explicit guidance as to how to determine the source of income attributable to production activities under the IFP method. However, the source of income attributable to sales activities is based generally on where title to the inventory passes to the purchaser as defined in § 1.861–7(c).

Section 1.863–3(b)(2) *Example 2* of the current regulations divides a taxpayer's income from Section 863 Sales equally between production activity and sales activity (50/50 method). The source of income attributable to production activity is based on the location of the taxpayer's property. The portion of this production income attributable to sources within the United States is determined by a fraction, the numerator of which is the taxpayer's property located within the United States used to produce income from Section 863 Sales, and the denominator of which is the taxpayer's property both within the United States and within a foreign country used to produce income from Section 863 Sales. The source of the taxpayer's income attributable to sales activity is based on where title to the inventory passes to the purchaser as defined in § 1.861–7(c).

Section 1.863–3(b)(2) *Example 3* of the current regulations allows a taxpayer to request permission from the District Director to use the taxpayer's books and records to allocate income to sources within and without the United States if those books reflect more clearly than the other methods the taxable income derived from sources within the United States (books and records method).

B. Issues Under Current Regulations

On July 12, 1995, the IRS and Treasury issued regulations under § 1.1502–13, treating members of a consolidated group as a single entity for purposes of determining the source of a taxpayer's income. The IRS and Treasury understand that the current section 863 regulations may raise questions when applied to certain consolidated groups on a single entity basis. The preamble to the regulations under § 1.1502–13 indicated that the IRS and Treasury would reevaluate part of the regulations under section 863. As part of this process, the IRS and Treasury also have reexamined the remainder of the existing section 863 regulations and have concluded that several additional changes are necessary.

First, the existing regulations were drafted more than 70 years ago, and have not been amended to reflect the evolution of business practices. As a result, the regulations have been the source of controversies in recent years. See *Intel Corporation* v. *Comm'r*, 100 T.C. 39 (1993), *aff'd*, No. 94–70105 (9th Cir. Oct. 16, 1995); *Phillips Petroleum* v. *Comm'r*, 97 T.C. 30 (1991), 101 T.C. 78, 104 (1993) (''there have been no cases interpreting [the 50/50 method] and no administrative pronouncements regarding its application since the regulation was promulgated in 1922 except for necessary inferences to be drawn from *Intel* * * *''), *aff'd*, No. 94–9021 (10th Cir. Nov. 28, 1995). In part, these controversies may be due to the structure of the current regulations, which do not contain operative rules to describe the methods of allocating and apportioning income, but instead rely on examples.

Second, the existing regulations raise important administrative concerns. For example, the IFP method requires an analysis of each of the taxpayer's sales transactions to identify an IFP. If one or more IFPs are so identified, a second analysis is required of each of the taxpayer's sales transactions to identify which transactions are similar to the IFP sale. In some cases, this process may require a review of a multitude of transactions. The IFP method may, therefore, be difficult for both taxpayers and the government to apply. The existing 50/50 method also presents administrative concerns. For example, the 50/50 method may require the taxpayer to determine the fair market value of each of its assets at the end of every tax year. Taxpayers have often commented to the IRS about the difficulties of determining the fair market value of their assets.

Third, the existing regulations result in disparate treatment of similarly situated taxpayers. Although an IFP must be used under current rules if one exists, the mandate applies only to taxpayers selling inventory to certain independent distributors. Taxpayers selling exclusively to related parties are not required to use the IFP method since the IRS may not establish an IFP based on such sales. Instead, these taxpayers use the 50/50 method to source their income from export sales. Thus, taxpayers selling inventory exclusively to related parties may be deemed to generate far more foreign source income than taxpayers selling a portion of their inventory to independent distributors, even though the two taxpayers may perform the same functions. The IRS and Treasury believe that this differing treatment of similarly situated taxpayers is not justified.

Fourth, the existing 50/50 method can result in apportionment of income that is inconsistent with the common understanding of that method. The 50/50 method is generally characterized as a method that would source export sales income one-half in the United States and one-half in a foreign country. For example, in 1984 the Treasury Department stated: ''Generally, [income derived from manufacture and sale of property] is allocated one-half on the basis of the place of manufacture and half on the basis of the place of sale * * *'' Treasury Department, Tax Reform for Fairness, Simplicity, and Economic Growth, Nov. 1984 at 364. In addition, Congress understands the 50/50 method to operate in this fashion. In 1986, the House, Senate and Conference Committees each stated: ''[Under the existing 50/50 method], half of such income generally is sourced in the country of manufacture, and half of the income is sourced on the basis of the place of sale''. House Rep. No. 426, 99th Cong. 1st Sess. 359 (1985); S. Rep. No. 313, 99th Cong. 2d Sess. 329 (1986); H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess. II–595 (1986). The staff of the Joint Committee on Taxation has referred to the 50/50 method as the ''production/marketing split'' and stated that under this method ''50 percent of such income generally is attributed to the place of production * * *'' Staff of the Joint Comm. on Taxation, Factors Affecting International Competitiveness of the United States 148 (1991).

The existing regulations may, however, allow taxpayers to use the 50/50 method to obtain results that are inconsistent with this common understanding. Under the existing regulations, 50 percent of the income is treated as sales income and sourced on the basis of title passage. The remaining 50 percent is treated as production income and sourced based on the location of assets. This half of the formula is not necessarily, however, limited to production assets. For example, goodwill and accounts receivables are counted as assets in allocating production income. The inclusion of sales assets in the formula allocating production income results in additional income being allocated to sales activities. The contribution of the sales assets to sales income should be reflected only in the 50 percent of the income that is allocated to sales and sourced under title passage. Thus, the production income formula should only take into account assets directly involved in the production of inventory.

B. Proposed Regulations

1. Overview

Section 1.863–3 provides rules for allocating and apportioning income from Section 863 Sales. Generally, § 1.863–3(b) provides three methods for determining the amount of gross income attributable to production activity and the amount of gross income attributable to sales activity. The source of gross income attributable to each activity is then determined under the rules of paragraph (c). Paragraph (d) provides rules to determine the source of taxable income. Reporting and election rules are set forth under paragraph (e) of the proposed regulations. The proposed regulations reserve on paragraph (f) (prior paragraph (c)), dealing with income partly from sources within a possession of the United States. The IRS and Treasury solicit comments from taxpayers regarding changes that should be made to new paragraph (f) (if any) to conform to the other changes in § 1.863–3.

The proposed regulations generally apply an aggregate approach in taking into account a taxpayer's interest in a partnership. The IRS and Treasury solicit comments on the appropriate treatment of partnerships, including whether there should be special rules for limited partnerships, de minimis interests in partnerships, and tiered partnerships.

2. Methods To Determine Gross Income Attributable to Production Activity and Sales Activity

Section 1.863–3 generally retains the three methods of the current regulations for splitting income between production and sales activity, with several modifications.

a. 50/50 Method

The proposed regulations do not change the allocation of half of the taxpayer's income from Section 863 Sales to production activity and half to sales activity. As described below, the proposed regulations modify and clarify the determination of the location of assets. In addition, paragraph (b)(1) of the proposed regulations makes the 50/50 method the general rule to determine the amount of income attributable to production and sales activities. The taxpayer, however, may elect to apply the IFP method, described in paragraph (b)(2), or, with the consent of the District Director, the books and records method, described in paragraph (b)(3).

b. IFP Method

By making the IFP method elective, the proposed regulations significantly reduce administrative burdens related to its application and eliminate any bias against taxpayers choosing to export through independent distributors.

Under the proposed regulations, the taxpayer may elect to apply the IFP method if it is able to establish an IFP. As in the current regulations, an IFP is fairly established by actual sales of the taxpayer if the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income attributable to production activity. Once the IFP is established, it can be used to determine the amount of income attributable to production activity in other Section 863 Sales if the inventory sold in the other sales is substantially similar in physical characteristics and function, and is sold at a similar level of distribution as the inventory sold in a sale establishing an IFP. A sale will not be considered to establish an IFP if sales activity for the relevant product is significant in relation to all of the activities for that product. The IRS and Treasury intend to supersede Notice 89–10 upon publication of final regulations.

The proposed regulations would also eliminate the existing rule permitting taxpayers to otherwise establish an IFP by showing to the satisfaction of the District Director that a sale reasonably reflecting the income attributable to production exists. This ''otherwise established'' IFP is rarely, if ever, used. American Law Institute, International Aspects of United States Income Taxation 31 (1987). The IRS and Treasury solicit comments from taxpayers on the continued utility of the otherwise established IFP.

The proposed regulations omit the reference in the existing regulation to a sales branch. A taxpayer may elect to use the IFP method even if it does not maintain a sales branch in a foreign country.

c. Books and Records Method

The proposed regulations retain the books and records method of the existing regulations, permitting taxpayers to request permission from the District Director to use their books and records to determine the income attributable to production and sales activities. The District Director will consider a taxpayer's request if the taxpayer maintains a detailed allocation of receipts and expenditures, clearly reflecting the amount of income from production and sales activities.

The books and records method is rarely, if ever, used. American Law Institute, International Aspects of United States Income Taxation, 31 (1987). The IRS and Treasury solicit comments from taxpayers on the continued utility of the books and records method, or whether the books and records method should be replaced by another method of economic sourcing.

3. Determination of Source of Gross Income

Unlike the current regulations which provide specific rules for determining the source of income attributable to production activity and sales activity only for purposes of the 50/50 method, the proposed regulations adopt rules applicable to each of the three methods. Under the proposed regulations, once gross income attributable to production activity and sales activity has been determined under one of the methods described in paragraph (b), the source of the income is determined separately for each type of income under paragraph (c). The source of gross income attributable to production activity is determined under paragraph (c)(1), based on the location of production assets, and the source of gross income attributable to sales activity is determined under paragraph (c)(2) based on the location of the sale.

a. Source of Gross Income Attributable to Production Activity

The proposed regulations generally adopt the approach set forth in the current regulations under the 50/50 method, but with modifications and clarifications.

Under § 1.863–3(c)(1), the source of income attributable to production activity is determined based on the location of the taxpayer's production assets. Thus, if a taxpayer manufactures inventory exclusively in the United States, all of its income attributable to production activity will be considered from sources within the United States. The rules described below are intended to apply only to taxpayers that produce inventory both within and without the United States.

Under the proposed regulations, the source of a taxpayer's income from production activities is determined by reference to the taxpayer's production assets, instead of all of its assets that produce income from Section 863 Sales. The IRS and Treasury believe that this change is appropriate to ensure that the source of production income corresponds to the location of production activity. Production assets are defined to include tangible and intangible property owned by the taxpayer that are used to produce inventory sold in Section 863 Sales. Any property not directly used to produce inventory is excluded. Thus, accounts receivable and marketing intangibles are excluded because they are sales assets and not production assets. Other assets excluded because they do not directly produce inventory are transportation assets, warehouses, inventory, work-in-process, raw materials, cash, investment assets, and stock of a subsidiary. Working capital is excluded to avoid uncertainty arising from determinations of the appropriate amount of working capital. In addition, working capital would generally be apportioned pro rata in accordance with a taxpayer's production assets. As under the current regulations, leased assets are excluded; only assets owned by the taxpayer are included.

The proposed regulations also provide specific rules for determining where a production asset is located. Tangible assets are located where the assets are used by the taxpayer. Intangible Assets are located where the tangible production assets to which they relate are located.

Where production takes place both within the United States and within a foreign country, the regulations apply a property fraction to apportion production income between U.S. and foreign sources. The taxpayer's foreign source gross production income is determined by multiplying its gross production income by a fraction, the numerator of which is the taxpayer's production assets located within a foreign country, and the denominator of which is the taxpayer's production assets located both within the united States and within a foreign country.

The current regulations generally include assets in the property formula at fair market value. The proposed regulations modify this rule to provide that an asset must be included in the property formula at its average adjusted basis (see section 1011). The IRS and Treasury believe that this change to adjusted basis will significantly simplify the application of this formula for both taxpayers and the IRS.

The proposed regulations also contain more detailed guidance than the current regulations for determining the amounts to be included in the property fraction. For example, the proposed regulations would require that if the asset is used to produce inventory sold in Section 863 Sales and is also used to produce other property, the basis of the asset must be prorated to account for such other uses.

The purpose of the property formula is to attribute the source of the taxpayer's production income to the location of its production activity. The IRS and Treasury are concerned that taxpayers may be able to affect the location of assets without changing the sit us of economic activity. Accordingly, comments are solicited about whether there should be rules to prevent manipulation of this formula in a manner inconsistent with the purpose of the regulation.

b. Source of Gross Income Attributable to Sales Activity

The source of gross income that is attributable to sales activity is determined under paragraph (c)(2). As under the current regulations, the source of this income is generally based on where a sale takes place. See § 1.861–7(c). Accordingly, if a U.S. producer sells its goods in a foreign country, the income attributable to sales activity is generally foreign source income.

The proposed regulation would retain the language of the existing regulation, which only applies to sales that occur within a foreign country. The IRS and Treasury solicit comments as to whether the regulations should be expanded to apply to sales made in international waters or in space. The IRS and Treasury are concerned, however, that if such a change were made, a U.S. seller may try to use the 50/50 method by selling inventory in international waters to U.S. purchasers, even when the goods were destined for the United States. In view of these concerns, the IRS and Treasury also solicit comments as to whether the regulations should provide an exception to the title passage rule in the case of sales of goods produced in the United States and destined for use in the United States.

4. Determination of Source of Taxable Income

Once the amount and source of gross income are determined under paragraph (c), taxpayers then determine the source of their taxable income. Under proposed paragraph (d), taxpayers must allocate or apportion under §§ 1.861–8 through 1.861–14T the amounts of expenses, losses and other deductions to its gross income determined under each method described in paragraph (b). In the case of amounts of expenses, losses and other deductions allocated or apportioned to gross income determined under the IFP method or the books and records method, the taxpayer must apply the rules of §§ 1.861–8 through 1.861–14T to allocate or apportion these amounts between gross income from sources within and without the United States. For amounts of expenses, losses and other deductions allocated or apportioned to gross income determined under the 50/50 method, taxpayers must apportion expenses and other deductions prorata based on the relative amounts of U.S. and foreign source gross income. These rules are consistent with existing regulations.

5. Election and Reporting Rules

Under paragraph (e) of the proposed regulations, a taxpayer must use the 50/50 method unless the taxpayer elects to use the IFP method, or elects the Books and Records method. The taxpayer makes the election by using the method on its tax return. Once The tax return is filed, the election is not revokable for that year. In addition, that method must be used in later taxable years unless the Commissioner or her delegate consents to a change. Permission to change methods in later years will not be withheld unless the change would result in a substantial distortion of the source of income.

A taxpayer must fully explain the methodology used in paragraph (b), and the amount of income allocated or apportioned to U.S. and foreign sources in a statement attached to its tax return.

6. Conforming Changes

The proposed regulations make conforming changes to § 1.863–2 of the regulations. Under § 1.863–2, the taxpayer may elect to apply the 50/50 method to its net taxable income, instead of its gross income as specified in § 1.863–3. The proposed regulations clarify that income derived from the purchase of personal property within a possession of the United States and its sale within the United States is subject to these regulations only to the extent it is not excluded by § 1.936–6(a)(5), Q&A 7. Other changes to § 1.863–2 were intended to conform the language of the regulation to the changes in § 1.863–3.

Finally, the IRS and Treasury will reconsider the existing regulations issued under section 863 regarding transportation services and cable and telegraph services in light of the Tax Reform Act of 1986. Accordingly, the transportation rules contained in § 1.863–4 will only apply to services that are not described in section 863(c) and the telegraph and cable rules contained in § 1.863–5 are deleted. No inference is intended as to whether portions of the existing regulations continued to apply after the Tax Reform Act of 1986.

7. Proposed Effective Dates

These regulations are effective for taxable years beginning 30 days after publication of final regulations. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 10, 1996, at 10 a.m. in the IRS Auditorium. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and an outline of topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 11, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Anne Shelburne, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.863–1 also issued under 26 U.S.C. 863.

Section 1.863–2 also issued under 26 U.S.C. 863.

Section 1.863–3 also issued under 26 U.S.C. 863.

Section 1.863–4 also issued under 26 U.S.C. 863.

Section 1.863–6 also issued under 26 U.S.C. 863. * * *

Par. 2. Sections 1.863–0 is added to read as follows:

§ 1.863–0 Table of contents.

This section lists captions contained in §§ 1.863–1, 1.863–2, and 1.863–3.

Par. 3. Sections 1.863–1, 1.863–2, and 1.863–3 are revised to read as follows:

§ 1.863–1 Allocation of gross income.

(a) *In general.* Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United States. See § 1.863–2 for alternate methods to determine the income from sources within or without the United States in the case of items specified in § 1.863–2(a). See also sections 865(b) and 865(e)(2).

(b) *Natural resources*—(1) *In general.* Except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, are allocated between sources within or without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section). Except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber outside the United States are also allocated between sources within or without the United States based on the fair market value of the product at the export terminal. The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of its fair market value at the export terminal (excess gross receipts) will be determined as follows—

(i) If the taxpayer does not engage in additional production activities (as defined in paragraph (b)(3)(ii) of this section), excess gross receipts will be from sources where the farm, mine, well, deposit, or uncut timber is located;

(ii) If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts must be determined under § 1.863–3. For purposes of applying § 1.863–3, only production assets used in additional production activity subsequent to the export terminal are taken into account; or

(iii) In all other cases, excess gross receipts will be from sources within the country of sale, as described in § 1.861–7(c). This paragraph (b)(1)(iii) applies, for example, to a taxpayer that engages in additional production activities in the country of sale.

(2) *Additional production prior to export terminal.* Notwithstanding any other provision of this section, gross receipts from the sale of products derived by a taxpayer who performs additional production activities as defined in paragraph (b)(3)(ii) of this section before the relevant product is shipped from the export terminal are allocated between sources within and without the United States based on the fair market value of the product immediately prior to the additional production activities. The source of gross receipts equal to the fair market value of the product immediately prior to the additional production activities will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of the fair market value immediately prior to the additional production activities must be determined under § 1.863–3. For purposes of applying § 1.863–3, only production assets used in the additional production activities are taken into account.

(3) *Definitions*—(i) *Production activity*. For purposes of this section, *production activity* means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864–1.

(ii) *Additional production activities*. For purposes of this section, *additional production activities* are substantial production activities performed by the taxpayer in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. Whether a taxpayer performs such additional production activities will be determined under the principles of § 1.954–3(a)(4). However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, be considered additional production activities for purposes of this section.

(iii) *Export terminal*. Where the farm, mine, well, deposit, or uncut timber is located without the United States, the export terminal will be the final point in a foreign country from which goods are shipped from a foreign country to the United States. Where the farm, mine, well, deposit, or uncut timber is located within the United States, the export terminal will be the final point in the United States from which goods are shipped from the United States to a foreign country. The export terminal is determined without regard to any contractual terms agreed to by the taxpayer and without regard to whether there is an actual sale of the products at the export terminal.

(4) *Determination of fair market value.* For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value under this section must be consistent with the arm's length price determined under section 482.

(5) *Determination of gross income.* To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) *Tax return disclosure.* A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any additional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by § 1.863–3.

(7) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. No additional production. US Mines, a U.S. corporation, extracts coal in the United States and, without substantial additional production, sells the coal in a foreign country. Under § 1.863–1(b) and (b)(1)(i), all of US Mines' income will be from sources within the United States.

Example 2. Scope of additional production. US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquified in preparation for shipment. The liquified natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under § 1.863–1(b) and (b)(1)(i), all of US Gas' income will be from sources within the United States.

Example 3. Sale in third country. US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in country X is $40, and that US Gold ultimately sells the gold jewelry in country Y for $100. Under § 1.863–1(b), $40 of US Gold's gross receipts will be allocated to sources without the United States. Under § 1.863–1(b)(1)(ii), the source of the remaining $60 of gross receipts will be determined under § 1.863–3. If US Gold applies the 50/50 method described in § 1.863–3, $20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale. US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market value of the oil at the export terminal in country Y is $80, and that US Oil ultimately sells the refined product for $100. Under § 1.863–1(b)(1), $80 of US Oil's gross receipts will be allocated to sources without the United States, and under § 1.863–1(b)(1)(iii) the remaining $20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export. US Furniture, a U.S. corporation, cuts trees in the United States, converts the trees into lumber, uses the lumber to manufacture furniture in the United States, and sells the furniture in another country. Assume that the fair market value of the trees when the conversion into lumber begins is $40, and that US Furniture ultimately sells the furniture for $100. Because the conversion of the trees into lumber is an additional production activity within the United States within the meaning of § 1.863–1(b)(3)(ii), the source of US Furniture's income will be determined under § 1.863–1(b)(2). Thus, $40 of US Furniture's gross receipts will be allocated to sources within the United States. The source of the remaining $60 of gross receipts will be determined under § 1.863–3. If US Furniture applies the 50/50 method described in § 1.863–3(b)(1), $20 of cost of goods sold is properly attributable to the additional production activity, and all of US Furniture's production assets used in the additional production activity are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

(c) *Determination of taxable income.* The taxpayer's taxable income from sources within or without the United States will be determined under the rules of §§ 1.861–8 through 1.861–14T for determining taxable income from sources within the United States.

(d) *Effective dates.* The rules of this section will apply to taxable years beginning 30 days after publication of these regulations as final regulations. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations. For years beginning before 30 days after publication of these regulations as final regulations, see § 1.863–1 (as contained in 26 CFR part 1 revised as of April 1, 1995).

§ 1.863–2 Allocation and apportionment of taxable income.

(a) *Determination of taxable income.* Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United States) will consist of gains, profits, and income—

(1) From certain transportation or other services rendered partly within and partly without the United States to the extent not within the scope of section 863(c) or other specific provisions of this title;

(2) From the sale of inventory property (within the meaning of section 865(i)) produced (in whole or in part) by the taxpayer in the United States and sold in a foreign country or produced (in whole or in part) by the taxpayer in a foreign country and sold in the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, to the extent not excluded from the scope of these regulations under § 1.936–6(a)(5), Q&A 7.

(b) *Determination of source of taxable income.* Income treated as derived from sources partly within and partly without the United States under paragraph (a) of this section may be allocated to sources within and without the United States pursuant to § 1.863–1 or apportioned to such sources in accordance with the methods described in other regulations under section 863. To determine the source of certain types of income described in paragraph (a)(1) of this section, see § 1.863–4. To determine the source of gross income described in paragraph (a)(2) of this section, see § 1.863–3. However, the principles of § 1.863–3 (b)(1) and (c) may be applied to determine the source of taxable income from sales of inventory property. To determine the source of income described in paragraph (a)(3) of this section, see § 1.863–3(f).

(c) *Effective dates.* This section will apply to taxable years beginning 30 days after publication of these regulations as final regulations. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations. For years beginning before 30 days after publication of these regulations as final regulations, see § 1.863–2 (as contained in 26 CFR part 1 revised as of April 1, 1995).

§ 1.863–3 Allocation and apportionment of income from certain sales of inventory.

(a) *In general.* This section applies to determine the source of income derived from the sale of inventory property (inventory) produced (in whole or in part) by a taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by a taxpayer in one or more foreign countries and sold within the United States (Section 863 Sales). For purposes of this section, a taxpayer's production activity includes production activities conducted by members of the same affiliated group as defined under section 1504(a). A taxpayer's production activity also includes production activities conducted through a partnership of which the taxpayer is a partner either directly or through one or more partnerships. A taxpayer subject to this section must divide gross income from Section 863 Sales between production activity and sales activity using one of the methods described in paragraph (b) of this section. The source of gross income from production activity and from sales activity must then be determined under paragraph (c) of this section. Taxable income from Section 863 Sales is determined under paragraph (d) of this section. Paragraph (e) of this section describes the rules for electing the methods described in paragraph (b) of this section and the information that a taxpayer must disclose on a tax return. Paragraph (f) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (g) of this section provides effective dates for the rules in this section. Once a taxpayer has elected a method described in paragraph (b) of this section, the taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales in foreign countries. In addition, the taxpayer must apply the rules of paragraphs (c) and (d) of this section by aggregating all Section 863 Sales to which a method described in paragraph (b) of this section applies. See section 865(i)(1) for the definition of inventory property; § 1.861–7(c) for the time and place of sale. See also section 865(e)(2).

(b) *Methods to determine income attributable to production activity and sales activity*—(1) *50/50 method*—(i) *Determination of gross income.* Generally, gross income from Section 863 Sales will be apportioned between production activity and sales activity under the 50/50 method as described in this paragraph (b)(1). Under the 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (c)(1) of this section. The remaining one-half of such gross income will be considered income attributable to sales activity and the source of that income will be determined under the rules of paragraph (c)(2) of this section. In lieu of the 50/50 method, the taxpayer may elect to determine the source of income from Section 863 Sales under the IFP method described in paragraph (b)(2) of this section or, with the consent of the District Director, the books and records method described in paragraph (b)(3) of this section.

(ii) *Example.* The following example illustrates the rules of this paragraph (b)(1):

Example. 50/50 method. (i) P, a U.S. corporation, produces widgets in the United States. P sells the widgets for $100 to D, an unrelated foreign distributor, in another country. P's cost of goods sold is $40. Thus, P's gross income is $60.

(ii) Pursuant to the 50/50 method, one-half of P's gross income, or $30, is considered income attributable to production activity, and one-half of P's gross income, or $30, is considered income attributable to sales activity.

(2) *IFP method*—(i) *Establishing an IFP.* A taxpayer may elect to allocate gross income earned from production activity and sales activity using the independent factory price (IFP) method described in this paragraph (b)(2) if an IFP is fairly established. An IFP is fairly established based on a sale by the taxpayer only if the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity. A sale will not be considered to fairly establish an IFP if sales activity by the taxpayer with respect to that sale is significant in relation to all of the activities with respect to that product.

(ii) *Applying the IFP method.* If the taxpayer elects to use the IFP method, the amount of the gross sales price equal to the IFP will be treated as attributable to production activity, and the excess of the gross sales price over the IFP will be treated as attributable to sales activity. If a taxpayer elects to use the IFP method, the IFP must be applied to all Section 863 Sales of inventory that are substantially similar in physical characteristics and function, and are sold at a similar level of distribution as the inventory sold in the sale fairly establishing an IFP. The IFP will only be applied to sales that are reasonably contemporaneous with the sale fairly establishing the IFP. An IFP cannot be applied to sales in other geographic markets if the markets are substantially different. The rules of this paragraph will also apply to determine the division of gross receipts between production activity and sales activity in a Section 863 Sale that itself fairly establishes an IFP. If the taxpayer elects to apply the IFP method, the IFP method must be applied to all sales for which an IFP may be fairly established for that taxable year and each subsequent taxable year. The taxpayer will apply either the 50/50 method described in paragraph (b)(1) of this section or the books and records method described in paragraph (b)(3) of this section to any other Section 863 Sale for which an IFP cannot be established or applied for each taxable year.

(iii) *Determination of gross income.* The amount of a taxpayer's gross income from production activity is determined by reducing the amount of gross receipts from production activity by the cost of goods sold properly attributable to production activity. The amount of a taxpayer's gross income from sales activity is determined by reducing the amount of gross receipts from sales activity by the cost of goods sold (if any) properly attributable to sales activity. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, and the source of gross income from sales activity will be determined under the rules of paragraph (c)(2) of this section.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (b)(2):

Example 1. IFP method. (i) P, a U.S. producer, purchases cotton and produces cloth in the United States. P sells cloth in country X to D, a unrelated foreign clothing manufacturer, for $100. Cost of goods sold for cloth is $80, entirely attributable to production activity. P does not engage in significant sales activity in relation to its other activities in the sales to D. Under these facts, the sale to D fairly establishes an IFP of $100. Assume that P elects to use the IFP method. Accordingly, $100 of the gross sales price is treated as attributable to production activity, and no amount of income from this sale is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100–$80).

(ii) P also sells cloth in country X to A, a unrelated foreign retail outlet, for $110. Because P elected the IFP method and the cloth is substantially similar to the cloth sold to D, the IFP fairly established in the sales to D must be used to determine the amount attributable to production activity in the sale to A. Accordingly, $100 of the gross sales price is treated as attributable to production activity and $10 ($110–$100) is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100 − $80) and $10 is attributable to sales activity.

Example 2. Scope of IFP Method. (i) USCo manufactures three dissimilar products. USCo elects to apply the IFP method. In year 1, an IFP can be established for sales of product X, but not for products Y and Z. In year 2, an IFP cannot be established for any of USCo's products. In year 3, an IFP can be established for products X and Y, but not for product Z.

(ii) In year 1, USCo must apply the IFP method to sales of product X. In year 2, although USCo's IFP election remains in effect, USCo is not required to apply the IFP election to any products. In year 3, USCo is required to apply the IFP method to sales of products X and Y.

(3) *Books and records method.* A taxpayer may elect to determine the amount of its gross income from Section 863 Sales that is attributable to production and sales activities for the taxable year based upon its books of account if it has received in advance the permission of the District Director having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures which clearly reflects the amount of the taxpayer's income from production and sales activities. If a taxpayer receives permission to apply the books and records method, but does not comply with a material condition set forth by the District Director, the District Director may, in its discretion, revoke permission to use the books and records method. The source of gross income treated as attributable to production activity under this method may be determined under the rules of paragraph (c)(1) of this section, and the source of gross income attributable to sales activity will be determined under the rules of paragraph (c)(2) of this section.

(c) *Determination of the source of gross income from production activity and sales activity*—(1) *Income attributable to production activity*—(i) *Production only within the United States or only within foreign countries*—(A) *Source of income.* Where the taxpayer's production assets are located only within the United States or only within a foreign country, the income attributable to production activity is sourced where the taxpayer's production assets are located. For rules regarding the source of income when production assets are located both within the United States and within one or more foreign countries, see paragraph (c)(1)(ii) of this section. For purposes of this section, *production activity* means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864–1.

(B) *Definition of production assets.* For purposes of this section, production assets include only tangible and intangible assets owned by the taxpayer that are directly used by the taxpayer to produce inventory described in paragraph (a) of this section. Production assets do not include assets that are not directly used to produce inventory described in paragraph (a) of this section. Thus, production assets do not include such assets as accounts receivables, intangibles not related to production of inventory (e.g., marketing intangibles, including trademarks and customer lists), transportation assets, warehouses, the inventory itself, raw materials, or work-in-process. In addition, production assets do not include cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary. A partner will be treated as owning its proportionate share of the partnership's production assets, determined by reference to the partner's distributive share of partnership income for the year attributable to such production assets.

(C) *Location of production assets.* For purposes of this section, a tangible production asset will be considered located where the asset is physically located. An intangible production asset will be considered located where the tangible production assets owned by the taxpayer to which it relates are located.

(ii) *Production both within the United States and within foreign countries*—(A) *Source of income.* Where the taxpayer's production assets are located both within the United States and within one or more foreign countries, income from sources without the United States will be determined by multiplying the income attributable to production activity by a fraction, the numerator of which is the average adjusted basis of production assets that are located in one or more foreign countries and the denominator of which is the average adjusted basis of all production assets in foreign countries and in the United States. The remaining income is treated as from sources within the United States.

(B) *Adjusted basis of production assets.* For purposes of paragraph (c)(1)(ii)(A) of this section, the adjusted basis of an asset is determined under section 1011. The average adjusted basis is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year, unless by reason of material changes during the taxable year such average does not fairly represent the average for such year. In this event, the average adjusted basis will be determined upon a more appropriate basis. If production assets are used to produce inventory sold in Section 863 Sales and are also used to produce other property during the taxable year, the portion of its adjusted basis that is included in the fraction described in paragraph (c)(1)(ii)(A) of this section will be determined under any method that reasonably reflects the portion of the assets that produces inventory sold in Section 863 Sales. For example, the portion of such an asset that is included in the formula may be determined by multiplying the asset's average adjusted basis by a fraction, the numerator of which is the gross receipts from sales of inventory from Section 863 Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset. For purposes of this section, a taxpayer's basis in production assets held through a partnership shall be determined by reference to the partnership's adjusted basis in its assets (including a partner's special basis adjustment, if any, under section 743).

(iii) *Examples.* The following examples illustrate the rules of this paragraph (c)(1):

Example 1. Source of production income. (i) A, a U.S. corporation, produces widgets that are sold both within the United States and within a foreign country. The initial manufacture of all widgets occurs in the United States. The second stage of production of widgets that are sold within a foreign country is completed within the country of sale. A's U.S. plant and machinery which is involved in the initial manufacture of the widgets has an average adjusted basis of $200. A also owns warehouses used to store work-in-process. A owns foreign equipment with an average adjusted basis of $25. A's gross receipts from all sales of widgets is $100, and its gross receipts from export sales of widgets is $25. Assume that apportioning average adjusted basis using gross receipts is reasonable. Assume A's cost of goods sold from the sale of widgets in the foreign countries is $13 and thus, its gross income from widgets sold in foreign countries is $12. A uses the 50/50 method to divide its gross income between production activity and sales activity.

(ii) A determines its production gross income from sources without the United States by multiplying one-half of A's $12 of gross income from sales of widgets in foreign countries, or $6, by a fraction, the numerator of which is all relevant foreign production assets, or $25, and the denominator of which is all relevant production assets, or $75 ($25 foreign assets + ($200 U.S. assets × $25 gross receipts from export sales/$100 gross receipts from all sales)). Therefore, A's gross production income from sources without the United States is $2 ($6 × ($25/$75)).

Example 2. Location of intangible property. Assume the same facts as *Example 1*, except that A employs a patented process that applies only to the initial production of widgets. In computing the formula used to determine the source of income from production activity, A's patent, if it has an average adjusted basis, would be located in the United States.

(2) *Income attributable to sales activity.* The source of the taxpayer's income that is attributable to sales activity will be determined under the provisions of § 1.861–7(c).

(d) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (c) of this section, the taxpayer must properly allocate and apportion separately under §§ 1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Sales determined separately under each method described in paragraph (b) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Sales under § 1.861–8(e)(3), the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of § 1.861–8(e)(3)(i)(A). In the case of gross income from Section 863 Sales determined under the IFP method or the books and records method, the rules of §§ 1.861–8 through 1.861–14T must apply to properly allocate or apportion amounts of expenses, losses and other deductions allocated and apportioned to such gross income between gross income from sources within and without the United States. In the case of gross income from Section 863 Sales determined under the 50/50 method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under the 50/50 method.

(e) *Election and reporting rules*—(1) *Elections under paragraph (b) of this section.* If a taxpayer does not elect a method specified in paragraph (b)(2) or (3) of this section, the taxpayer must apply the method specified in paragraph (b)(1) of this section. The taxpayer may elect to apply the method specified in paragraph (b)(2) of this section by using the method on a timely filed original return (including extensions). A taxpayer may elect to apply the method specified in paragraph (b)(3) of this section by using the method on a timely filed original return (including extensions), but only if the taxpayer has received permission from the District Director to apply that method. Once a method under paragraph (b) of this section has been used, that method must be used in later taxable years unless the Commissioner consents to a change. See e.g., paragraph (b)(2)(ii) *Example 2* of this section. However, if a taxpayer elects to change to or from the method specified in paragraph (b)(3) of this section, the taxpayer must obtain permission from the District Director instead of the Commissioner. Permission to change methods from one year to another year will not be withheld unless the change would result in a substantial distortion of the source of the taxpayer's income.

(2) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (b) of this section must fully explain the methodology used, the circumstances justifying use of that method, the extent that sales are aggregated, and the amount of income so allocated.

(f) *Income partly from sources within a possession of the United States.* [Reserved]

(g) *Effective dates.* The rules of paragraphs (a) through (e) of this section will apply to taxable years beginning 30 days after publication of final regulations. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations. For years beginning before 30 days after the publication of these regulations as final regulations, see § 1.863–3 (as contained in 26 CFR part 1 revised as of April 1, 1995).

Par. 4. Section 1.863–4 is amended by revising the section heading and paragraph (a) to read as follows:

§ 1.863–4 Certain transportation services.

(a) *General.* A taxpayer carrying on the business of transportation service (other than an activity giving rise to transportation income described in section 863(c) or to income subject to other specific provisions of this title) between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

* * * * *

§ 1.863–5 [Removed]

Par. 6. Section 1.863–5 is removed.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

[FR Doc. 95–30087 Filed 12–7–95; 2:00 pm]

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DEPARTMENT OF TRANSPORTATION

Office of the Secretary

33 CFR Part 52

[OST Docket No. OST–95–878; Notice 95–14]

RIN 2105–AC31

Coast Guard Board for Correction of Military Records; Procedural Regulation

AGENCY: Office of the Secretary, DOT.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Department proposes to amend its regulations with respect to reconsideration of final decisions of the Board for Correction of Military Records of the Coast Guard (Board). This action is taken on the Department's initiative in order to streamline processing of these cases and to clarify the circumstances under which final decisions can be reconsidered. The proposed amendment will make it possible for the Board to expedite reconsideration and will increase the resources available to meet the requirement that all cases be decided within 10 months of the receipt of a completed application.

DATES: Comments must be submitted on or before February 9, 1996. Late-filed comments will be considered to the extent practicable.

ADDRESSES: Comments should be mailed, preferably in duplicate, to Docket No. OST–95–878, Documentary Services Division, C–55, PL–401, U.S. Department of Transportation; 400 Seventh Street SW, Washington, D.C. 20590. Comments will be available for review by the public at this address from 9 a.m. through 5 p.m., Monday